RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Sept. 21, 1988 **LETTER 1000**

THE MARKET: The great 1974-87 bull market ended on August 25, 1987 at Dow 2722.42. At that point a primary bear market started. The first bear leg took the Dow from its August 25 high down to a September 21 low of 2492.82. A brief secondary correction rallied the Dow back to 2640.99 on October 2. From the October 2 peak, a second primary decline sent the Dow tumbling down to its historic crash low of 1738.74 on October 19.

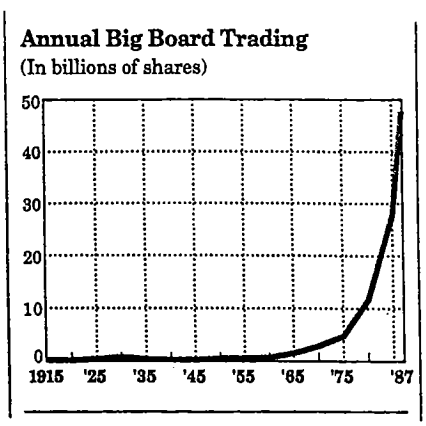
Since October 19 the market has been recovering from the greatest crash (in terms of both Dow points and Exchange volume) in Wall Street history. It stands to reason that history's greatest crash could be followed by an "unusual" rebound.

Actually, the correction/recovery from the 1987 crash has been far less in extent than I would have expected; in duration, it has been a record-breaker. As this is written, eleven months have elapsed since the crash, yet the Dow at its July 1988 recovery high had recouped only 43% of its August to October 1987 bear market losses. As this is written, the Dow is only 80 points above where it closed two-days after the crash -- in all, a weak and sub-standard performance.

The action during the eleven months since the crash has been erratic, tedious, but at times violent. There have been no less than 20 instances since October 19 when the Dow has rallied 20 points or more in a single day. And since October 19 there have been five instances in which the Dow has rallied 40 points or more in a single day. With that kind of record, you'd think that the Dow would be somewhere up in the stratosphere by this time. Not so. Following each "one-day upside wonder," the Dow has dribbled off -- slowly but surely giving back the points that had been so exuberantly gained on the rally.

What does it all add up to? As I see it, the bear is simply biding his time, playing with the players. This form of Wall Street "entertainment" will probably continue until the bear decides that it's time to get serious (and nasty) again.

VOLUME: a subscriber (he's a specialist on the NYSE) sent me this chart with the following comment: "How is this for a parabolic curve ! ! !" Russell comment: For the benefit of new readers, once a parabolic curve tops out (which the parabolic volume curve on the NYSE now has) a long decline (often lasting many years) can be expected to follow. In other words, volume on the NYSE has topped out for the duration.

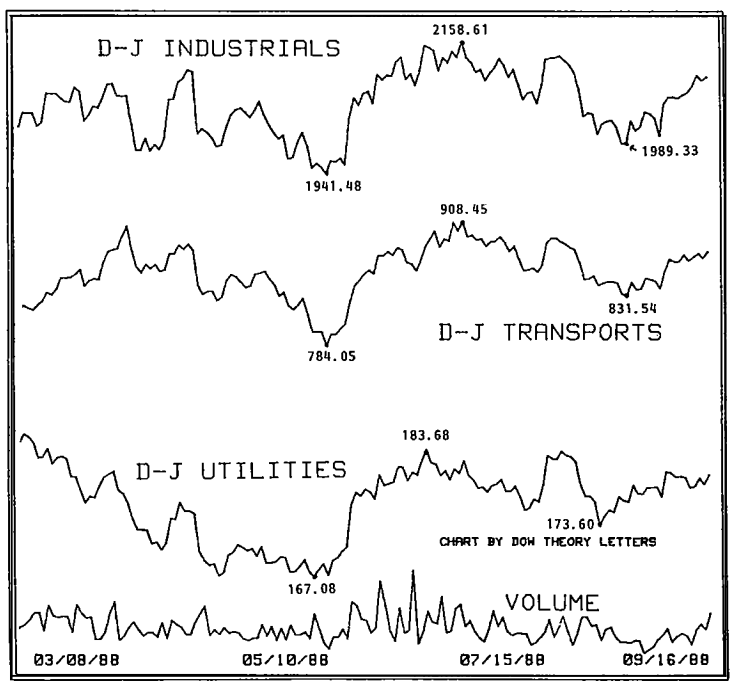


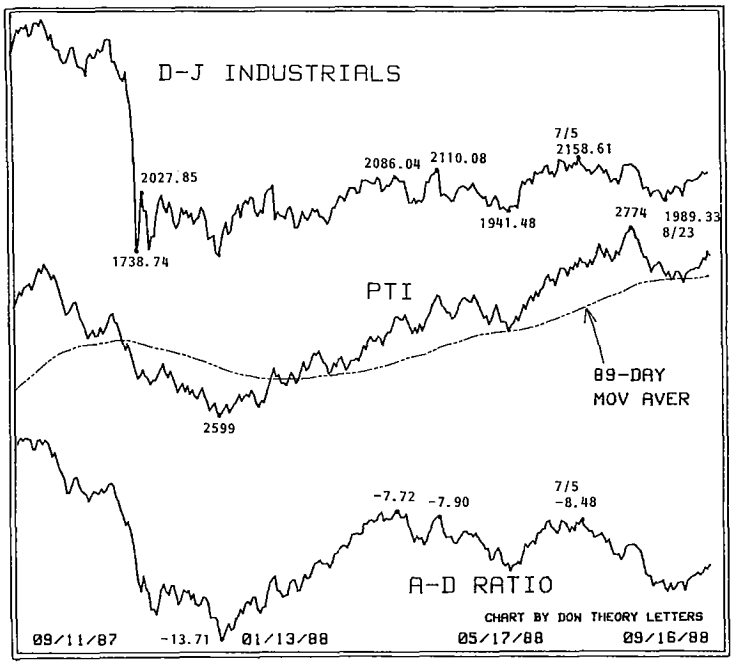
Sept. 9 DJIA 2068.81; PTI 2736; A-D Ratio -10.93
Sept. 16 DJIA 2098.15; PTI 2751; A-D Ratio -10.57
Current Dow Yield: 3.68%; Dow P/E: 12.4
Dow 200-day MA: 2021; DowPow: 802
Percentage of undervalued blue-chip stocks: 21%

My **Primary Trend Index** (PTI) has been fluctuating a few points either side of its 89-day moving average. It is (and this is rare for the PTI) trendless at this time. . . . Meanwhile, **DowPow** (at 799) remains in its extended trading range, but closer to its December 4th low of 519 than its March 8th high of 1166. Perhaps more than any other indicator, DowPow has given me a "feel" for what this bear market is doing. All right, what is the bear market doing? It's wearing traders and investors out, killing commissions and profits on Wall Street, and keeping both the bulls and the bears hoping.

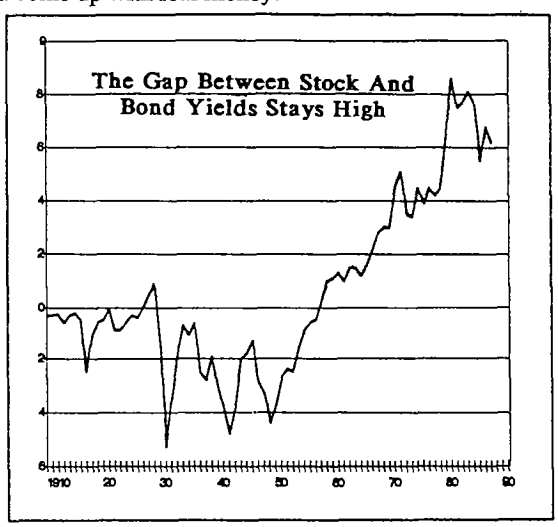
DowPow is the Dow adjusted for the action of the advance-decline ratio. The A-D figures during the entire recovery from the crash lows have been surprisingly poor. The A-D action on the rally since August 23 has been absolutely dismal (see page 2 chart). Since August 23 the Dow has rallied over 100 points, while the A-D ratio has gained just slightly over one full point. Conclusion: The majority of stocks are increasingly reluctant to move on the upside when the Dow rallies -- hardly a healthy sign.

INVESTMENT POSITION: The bear is still king of the box. The latest producer price index pegs inflation at 7%, but on Sept. 12 crude oil broke below $14 a barrel and in sympathy gold plunged below 420. Thus, the market (via oil and gold) refuses to believe that inflation is a problem (if we were to be guided by the oil/gold action, it would appear the market is more worried about deflation).





Following this logic, high-grade (and I stress HIGH-GRADE) bonds are desirable on the basis of attractive yields and as a hedge against possible deflation. Furthermore (refer to the chart), on the basis of bond yields vs. stock yields, bonds are obviously the real value. Note that the yield spread in favor of bonds over stocks is now 6%. Compound a 6% advantage over a period of 10 years and you come up with real money.



BONDS: Back in Letter 991 I presented a study of the long-term yield cycle, and I included a chart showing the cycle of interest rates going back to 1800. I have included that same chart in the insert of this larger bond chart. (See page 3; the larger chart is courtesy of *Ned Davis Research, Inc.*.)

Referring to the insert, note that unlike the time element of bull and bear markets in stocks, the swings (or cycles) in interest rates tend to take decades to complete. The latest major cycle in rates began in 1946 (right after WW II) at which time Treasury bonds were in the 3% yield range. By 1980, yields on Treasury bonds (during the Carter inflation crisis) had risen above 15%. That, in my opinion, was the top, the peak for interest rates for the entire cycle since 1946.

My belief is that we are now in the early stages of a bull market in bonds. It should be a long bull market. Considering that the bond bear market lasted 34 years (1946-80), it would not surprise me if the bull market took just as long. But it is not necessarily going to be an easy or painless bull market. The bond bull market will be based, among other things, on liquidation of debt and a return to conservatism. In the early stages of the bond bull market, I think we will see many shake-outs in bonds, possibly one or more interest rate spikes, plus a very unpleasant and painful liquidation (i.e., bankruptcy) of junk bonds and lower-grade bonds. But through all this I do not believe we will see the 1980 high of 15% in long-term Treasury rates again. That 15% rate should stand as the high.

Now let's turn to the *Ned Davis* chart. This chart traces the long, painful bear market in bonds as measured by the D-J 20 Bond Average. The bear market began in 1946 with the 20 Bonds at 128; the bear market ended in 1982 with the 20 Bonds below 58, a loss of 55% for the bonds.

But what has occurred since is most interesting. It is a picture that I have been following with increasing interest for many years. First we see that in 1986 the 20 Bonds broke above the long declining trendline which extends from 1946 through (or near) four descending peaks. I believe the 1986 reversal of this bearish trendline is very significant.

Next, we see what could be the formation of a huge head-and-shoulders bottom formation in the 20 Bond Average. I have marked the left shoulder with an "a", the head or bottom with a "b", and the right shoulder with a "c". This formation is the second step to what could be a historic reversal.

I have been recommending bonds through the entire rise, since point "b". I continue to recommend bonds with particular emphasis on high-grade (AA-rated or better) municipal bonds.

For neophyte bond buyers and newer subscribers, you must remember that a bond, unlike a stock, possesses a guarantee. That guarantee states that upon maturity (or when "called") the bond will be redeemed at par, which in most cases is $1,000. Thus (unlike stocks), and this is a very important concept, even when bonds are in a major bear market (such as 1946 to 1980), the bondholder, if he or she holds the bond to maturity, will receive par or $1,000 for those bonds. A bear market in bonds obviously affects the pricing or yield on new bonds, but as older bonds move nearer to their maturity dates, their prices will rally against the forces of the bear and toward their redemption value of $1,000 or par.

In a bond bear market, this is obviously a very comforting thought, except for one item -- your bond, when redeemed at $1,000, will be paid off in current dollars, and during 1946 to 1980 the value or buying power of the dollar (due to the ravages of inflation) collapsed. Since bonds (unlike stocks) do not have the ability to raise their payout, they cannot hold their purchasing power during periods of inflation. Thus, the 1946-80 years of rising inflation and declining bond prices gave bonds a bad name. In fact, one advisor became famous for labeling bonds "guaranteed certificates of confiscation." Of course, he was merely talking about the effects of inflation on all fixed-income investments.

But in investments, change is the constant. Last year's dog may be this year's prize. My feeling is that the bond situation may be changing. It may be that the age of inflation in America is moving into the age of stability or even the age of deflation and debt liquidation. At any rate, for whatever reason, bonds have reversed the long, bearish trendline in price, and they are now forming a potential head-and-shoulders bottom and reversal.

Russell opinion: I believe that a " youngish" investor (i.e., someone under 45 years of age) will do well embarking on a policy of buying high-grade bonds and then compounding that investment by reinvesting the interest. The ideal is to live off your salary or earnings and to act as if you didn't even know that your bond portfolio existed. In other words, live off part of your salary, save the rest of your salary, and place those savings together with all bond interest in new bonds. Aside from inheriting money or

marrying into it, this (compounding) is the only guaranteed path to riches that I am aware of.

Let me state this principle in a very simple but basic form -- "DON'T PAY INTEREST, COLLECT IT." Any time you are paying out interest, someone else is making a profit on your labor. Any time you are collecting interest, you are profiting from the fruits of your labor. The foregoing is probably the best advice I could give anyone having anything to do with handling their own investments.

Thanks to my old friend, Julie Snyder of *International Moneyline* (PO Box 58, St. Moritz, Switzerland) for this section from the book, "Secrets of the Temple" by William Greider (Simon & Schuster). The following long quote is, in my opinion, so informative that I just couldn't resist including it in this Letter.

"The bond market and the Fed were kindred spirits, both wanting the same things, stable prices, sound money, order. Bondholders depended on the Federal Reserve to protect their wealth, because as inflation cheapened the value of the dollar, it directly eroded the value of their long-term financial assets. For the last decade, long-term inflation had devasted the market for corporate bonds.

"But the bond market was also a critic, a skeptical audience that continuously assessed the Fed's performance and regularly scolded errors or lapses. When governors from the central bank worried aloud about their 'credibility,' they meant in particular -- did the bond market really believe their promises to control inflation? When bond traders bid up interest rates, it meant that, all things considered, they did not trust the Fed to protect the future value of money. Volcker and other governors worked continuously to persuade them and win their good opinion.

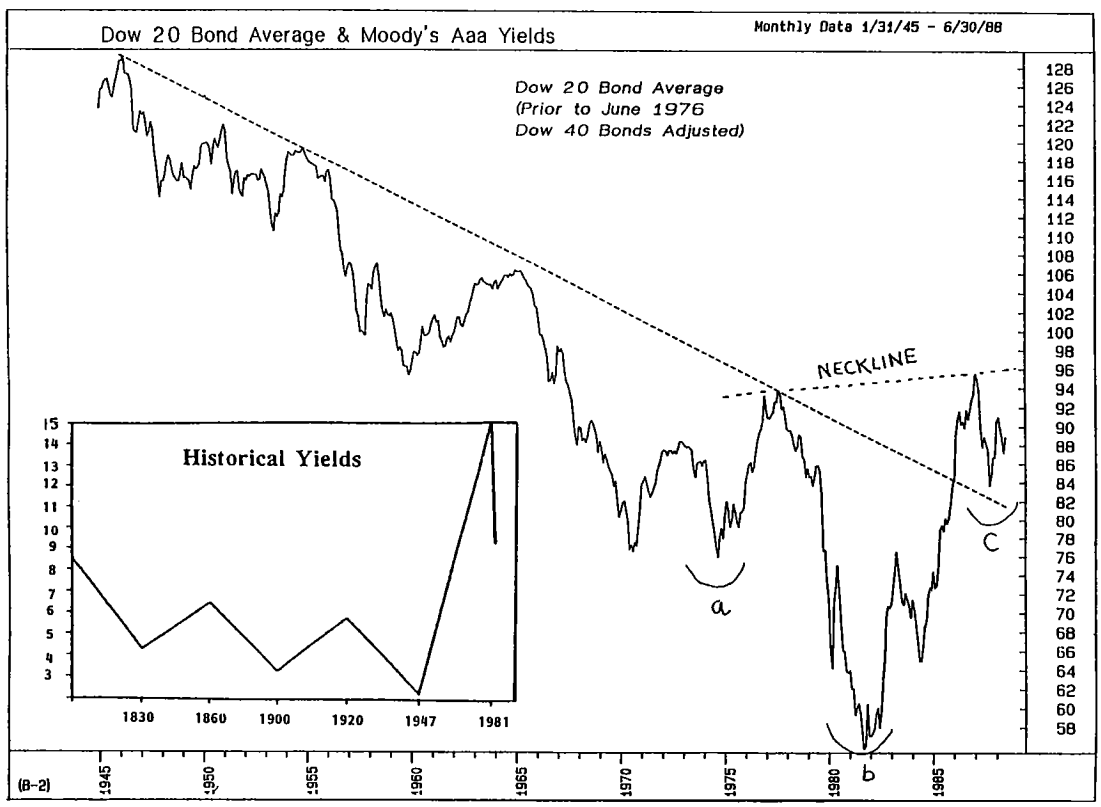
"Bondholders, in particular, did not necessarily want the same thing everyone else in the country wanted from the economy, and they often seemed perversely narrow-minded in their reactions to events. Bonds rallied on bad news and sulked over good news. If the government announced a sharp decline in retail sales or manufacturing output, the price of bonds rose. If Washington reported a quarter of healthy growth for the GNP, bond prices sagged. Bond investors were preoccupied with one question about the nation's economic performance -- not the actual results in production, income and jobs, but how everything would affect the future value of their dollars. An economy expanding robustly heightened their fears. A weak economy assured the bondholders that their money was safe.

"The bondholders were one of the oldest, most influential interest groups in American politics, yet their presence had nearly vanished from political discourse. Financial wealth, like so many other aspects of American life, had become bureaucratized over the years: wealth was now held in large, impersonal institutions that diffused its visibility. In crude terms, nevertheless, the bondholders had not changed much since Andrew Jackson's time -- they were the wealthiest individuals and financial institutions that owned most of the capital invested in long-term debt paper, including the US government's.

"Among individuals, for instance, the top 10% of American families owned 72% of corporate and federal bonds held by individuals plus 86% of state and local bonds. Among institutions, commercial banks owned about 20% of the outstanding Treasury debt (roughly the same share held directly by wealthy families) and another 10% was owned by insurance companies and other corporations. Private wealth was, of course, redundant -- the same people likely to hold the bonds in their personal portfolios also owned, disproportionately, the stock of the corporations and banks that owned bonds. The wealth holders represented the conservative hand of the past, but capitalism had no future without their cooperation. Paul Volcker prefered to call them 'the forces for stability'."

Russell comment: Alan Greenspan has taken over from Paul Volcker as Fed Chairman, and I'm sure that Greenspan feels tremendous pressure not to undo the work of Volcker. Whether it is true or not, it is generally conceded that Paul Volcker was the White Knight who "killed inflation in America." In my opinion, the last thing Greenspan wants is to go down in history as "the man who undid Volcker's work and allowed inflation to heat up again." Therefore, watch the Fed and its actions. I'm convinced that on any sign of real inflation, Greenspan will move to stifle inflation via higher interest rates -- even at the risk of a recession.

But with today's almost unsustainable levels of debt, Greenspan knows only too well how dangerous the next recession will be.



Thus, Greenspan and the Fed are now walking the tightrope between prosperity and recession. Against Greenspan and the Fed are time and the bear market in stocks. The economic expansion is now pushing toward a record 70 consecutive months, and therefore time is now running against the expansion. Furthermore, the bear market in stocks is basically deflationary. I think the bond market recognizes all this, and that is the reason why bonds have acted so well since the crash. The other reason bonds have acted well, of course, is that (in my opinion) bonds are caught up in a long-term bull market.

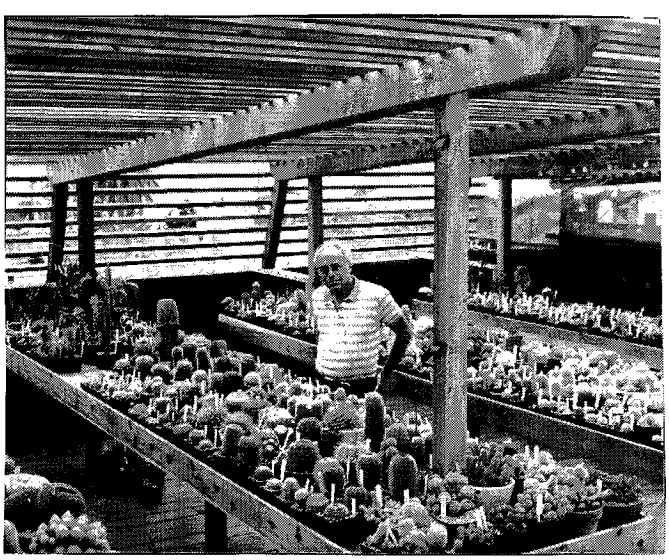
Even more than the Fed (and I've stated this many times before), the bond market itself appears to be running the nation. If inflationary signs appear, bondholders get nervous and sell or bid down bonds and consequently interest rates rise. If bondholders are satisfied that inflation is under control, they will bid bonds up and interest rates will consequently decline. When the Fed recently boosted the discount rate from 6% to 6.5%, they were simply following the money market in which Fed Funds were almost 2% above the discount rate -- a spread which almost always calls for a rise in the discount rate.

We are not living in the 1960s or 1970s when the money markets were relatively naive regarding inflation. Times have changed, and the money markets today are vastly larger and infinitely more sophisticated. Thus you can see that in order for inflation to start up again, the money markets would have to be fast asleep. And that's not going to happen. So as I see it you can kiss serious inflation good-by; it died when the money markets finally got smart.

RELAXING: How do you relax when you're in a business which requires you to put yourself on the line week after week and year after year? I do it by watching things grow. What I watch is cacti, hundreds of them. I've been fascinated with cacti ever since I was a kid of 15. Back in New York City I would try to grow my cacti, but all my efforts only ended in frustration. Unless you have a greenhouse (and I lived in midtown Manhattan), you are not going to do very well with cacti in a city.

So my ambition was to move to California, the land of sun, surf, desert -- and cacti. Once I got Dow Theory Letters established, I had my chance. I moved out here in 1961. I immediately did two things: I bought a motorcycle (it was a BMW) and I started a cactus collection.

I haven't been without either since except for a few months here and there. This year I built a lathe house for my cacti. They love it. I spend an hour or so a day messing around with my hundreds of cacti. I watch them grow. I forget all about Wall Street and the stock market and everything else that worries me or strains my tired brain.



I recommend watching things grow. It doesn't matter if it's grass or trees or puppies or kids or orchids. But it should be something alive, something that's part of nature, something near God. Anyway, that's my hobby. Here's a picture of me with my little spiny friends. I know it's nutty, but they fascinate me.

NOTES and QUOTES: You may not have noticed, but I did -- this is Dow Theory Letters No. 1000. After 30 years of writing these reports (I started in late-1958), I've finally written 1,000 Letters. When I first started this business, I had no idea that I'd still be at it in 1988 -- or 1978 for that matter. But here I am, and I'm just as fascinated with the stock market as I was when I first began to study Wall Street in 1945.

I like to think that I'm a learner, and I frequently write about things that interest me and things that I've learned. My subscribers either like these items or at least tolerate them, so I continue. As veteran subscribers know, I'm also a voracious reader, and when I read an item that interests me, I'm eager to pass it on to my subscribers -- which I do.

* *

Warren Buffet (Berkshire Hathaway) started his partnership back in 1956, and if you had placed $10,000 with Buffet back in '56 and reinvested the proceeds in Berkshire Hathaway after Buffet disbanded the partnership, your original $10,000 would be worth $15 million today. I started Dow Theory Letters two years after Buffet set up his partnership, but obviously I never did as well on the profit side of the ledger as did Mr. Buffet. But I've done pretty well, and I'm sure I've had as much fun and excitement doing it as Buffet has -- and that's what counts. "Love and work," wrote Freud, "that's all there is." Freud won't get any argument from me on that quote.

I've always been a Buffet fan, and I've followed his career for years. There's an excellent article in the current (October) issue of *Esquire* on Buffet entitled "The Modest Billionaire." In it Buffet espouses a good bit of his philosophy, and the article is well worth reading. As you might have guessed, I agree completely with what is said below:

> "In the securities business," he said, "you're a batter in a game in which there are no called strikes. They can throw you General Motors at 40 and you don't have to swing. They can throw you IBM at 120 and you don't have to swing. They have to keep pitching, so if you're patient, the odds are with you. You can wait until you get one right where you want it."
>
> "You might not swing for six months."
>
> "You might not swing for two years. If you have impatient shareholders, they start hollering, 'Swing, you bum.' "
>
> "Isn't it boring, standing with a bat on your shoulder for two years?"
>
> "It can be, and boredom limits the capabilities of many money managers."
>
> BUFFETT SAYS he has always followed the principles of Ben Graham, author of the classic textbook *Security Analysis*. Graham preached that the first rule of investing was not to lose. You invested only when you found an investment that was selling for less than a rational buyer would pay, by a wide margin of safety. According to Graham, following the market is like having a manic-depressive as a partner. Sometimes Mr. Market becomes so giddy he will ignore all reality and offer you outrageous sums of money for your part of the business. Sometimes he falls into despair, and he will offer you his share of the business at a discount so silly that you buy it. In between, you keep your bat on your shoulder. It seems too simple to be true.
>
> "Money is a by-product of doing something I like to do very much," Buffett says.

> "If Ted Williams was getting the highest salary in baseball and hitting .220, he'd be unhappy, and if he was getting the lowest salary and hitting .400, he'd be very happy. That's the way I feel about this job.
>
> "I pick managers in my businesses who love what they do and who aren't trying to build a résumé or make money for themselves. They're wedded to what they do. They keep doing it even after they have a lot of money.

* *

The current presidential campaign is the worst I can ever remember. Neither candidate is addressing any important issue; instead they yammer on about such earth-shaking issues as school prayer or each other's patriotism or lack of it. America seems hungry for anything that sounds like good news so Bush talks about "never raising taxes" while promising years of continued prosperity and 30 million new jobs. Meanwhile, Dukakis implies that Bush is an unpatriotic wimp, and carries on about the prosperity that he, Dukakis, will create if only we will elect him. I've grown disinterested in what either candidate says or promises and disenchanted with the whole dismal campaign. Never have two presidential candidates avoided so many major issues. "Or are the real issues too frightening to contemplate?" I muse.

* *

Just talked to two friends back from two months in Japan. Their comments: Japan sees US as a big fat, inefficient nation that is sinking slowly into the sunset. Japan sees itself as the wave of the future. Japanese are anti-Semitic, anti-black, anti-Korean, anti-everything, but Japanese. Wealth in Japan is mind-blowing -- many teenagers wearing Rolexes, gold jewelry. Japanese women stand in line to buy the latest full-priced designer clothes and accessories. Poverty almost non-existent in Japan, crime extremely low. Average Japanese family has savings of $80,000. Japan is worried about health of the US economy, and they are now making major efforts to become established in the markets of China and Russia.

Meanwhile, a complacent US is losing the high-tech battle. The Council on Competitiveness (made up of 151 CEOs), in a recent study, states that "in 1987 our trade balance with Japan in electronics was almost as large as it was for autos." Council finds: Between 1970 and 1988 the US share of consumer electronics fell from 100% to 5%; color TV sales fell from 90% to 10%; phones from 99% to 25%. Since 1983 Japan has introduced 60 new drugs, the US 58. . . . Nearly half the assistant professors and engineering students in the US are foreigners. The US has lost the lead in turning technology into products.

While Japan and the "Asian Tigers" are fighting the battle for leadership in world production and technology, the US finds itself spending billions in its losing fight against drugs. Speaking of drugs, the latest estimate is that the profits of the South American drug cartel is now running a cool $1 billion a year. In contrast, let it be noted that the US defines the "poverty level" as a family of four with an average income of $11,600 or less. On this basis, one-third of all black families in the US are living at or below the poverty level.

The theory was that a cheaper dollar would help the US export situation. Has it helped? Not in the vast auto market it hasn't. According to R.L Polk data, market share of Japanese autos in the US has risen from 28% in 1985 to 36% in 1987. In the same period, California (the trend setter) has seen Japanese car share rise from 48% to 57%.

* *

Sign of the times: For the first time in its 115-year history, the Caucasian student body of UC Berkeley is down to 48%. Said University spokesman Ray Colvig, "Every student here is now a minority." . . . Los Angeles County now has a larger population than 42 of the 50 states. . . . By 1990 there will be one lawyer for every 310 people in the US.

* *

Muni bonds are becoming scarce and have been acting far better than either industrials or Treasury bonds. This clip is from the Sept. 13 *Investor's Daily:*

> Fueled by a tight supply and investors' fears that higher taxes may be forthcoming, municipal bonds have surged ahead of other government bonds this summer, and both bond traders and bond fund managers say tax-exempt munis will continue to lead the bond market.
>
> "We're expecting a continuation of lower-than-expected supply and heavier-than-envisioned demand for the product and a growing perception that you've got to protect yourself against future taxes," said Jim Erickson, chief investment officer of Putnam Cos.' Tax-Exempt Income/Cash Management group.

* *

New York magazine (Aug. 29) features an article on the widespread panhandling in the City. They state that at rush-hour New Yorkers are greeted by a minimum of 5,000 panhandlers.The article continues, "For those who are the target of panhandlers' appeals, the tableau is bewildering and frightening. Able-bodied young men approach passersby with bullying demands that may be the result of simple rage, crack use, or the knowledge that intimidation can increase income. Pretty young women work the midtown streets with signs saying they were abandoned by their boyfriends and need money to get home; one woman has been raising airfare to California for five months now. Mothers in welfare hotels send their eight-year-olds out to beg in the middle of the night and won't let them back in until they have reached their quota. . . . In four weeks of interviews with panhandlers on streets and subways a picture of the new beggar emerged: Young, apathetic, uneducated, the product of grinding poverty, he has left the economic system and has no thought of return. He drifts from soup kitchen to drop-in center or shelter, panhandling along the way, spending his take on fast food or crack or cigarettes or beer. Unless he has a scam, he makes no more than $10 or $15 a day."

* *

On to San Diego where this excerpt from Neil Morgan's column (*SD Evening Tribune*, Sept. 13) tells you something about real estate here in Southern California: "At Fairbanks Ranch . . . agent Brenda Mittlemann discussed recent clients: "This lovely Korean couple -- his name is Sam Surh and he deals in aircraft parts -- were really in love with one of our multimillion-dollar houses. They decided to think about it overnight. In the meantime Kumie Tsuchido came along. She has a kimono design firm in Tokyo and her husband, Tomoo Isome -- well, his family is in dentistry. They came to buy some lots. But they took one look at this house and said they'd buy it. It really was a great house; I think it'll be the Designers' Showcase house next summer. Well, the Koreans came back next day and I had to tell them their house was gone, but I said, wait a minute, there's another house you might like even better, and sure enough they did. You know, to these people, with the dollar the way it is, property looks cheap. Back at the office, these people were literally waiting in line to sign the papers. For me, I might as well tell you, it was a $4 million day."

* *

The Russians (don't laugh) are serious about getting into baseball. Under construction now at Moscow State University -- the first Russian baseball field. It's being financing (are you ready for this) through a $3 million gift by Dr. Shigeyoshi Matsumae, president of Tokai University in Japan.

* *

My father died of a heart attack in 1956. My dad used to eat two eggs every day for breakfast, lots of butter on his toast, lots of cream in his coffee, plenty of salt on all his food. Almost everything we know about hearts has been discovered since then. Dr. Michael DeBakey, renowned heart specialist, describes the changes in medicine in the last 25 years as "a fast trip from the Dark Ages to the 21st Century." Says DeBakey, "In the early 1950s when I was a medical student there was nothing you could do for most heart patients. The primary treatment at that time was rest. Patients who lived remained hospitalized for approximately six weeks and then went home and stayed in bed another three or four months. . . . The patient either got well or died. . . . People of my generation have seen, observed and participated in a revolution in cardiac treatment. During that time, surgeons have learned to cure some types of heart diseases including aneurysms and correct about 80% of congenital heart diseases."

Today in addition to heart bypasses there are heart transplants, artificial respirators, heart-lung machines which keep the blood circulating during open-heart surgery, cholesterol-lowering drugs, and on and on. The wave of the future -- technology for clearing away fatty deposits from the arteries via lasers or other methods (they're using laser technology on clogged leg arteries now).

* *

For complete freedom my old buddy, Harry Schultz (who has lived in almost every civilized nation), recommends being a citizen of one country, being domiciled in a second country and living in a third country. R.E. McMasters of *The Reaper* (PO Box 84901, Phoenix, AZ 85071) goes even further. He believes that "it is best to be a citizen of one country, live in a second country, bank in a third country (like Switzerland), have your business and operate out of a fourth country (perhaps Bermuda), and market a product out of a fifth country (like Canada). R.E. states, "This type of widespread distribution of persons, asssets, power base, political moorings, business base and tax liability maximizes freedom. Remember, under the religion of humanism, the state really believes it owns its citizens. . . . For example, an English taxpaying productive citizen living in the US is treated with more respect and a more 'hands-off' approach by American bureaucrats than a US citizen. That's the way it works pretty much in every developed country of the world." Russell comment: Sounds good, R.E., but all those different checking accounts would drive me up the wall.

* *

In 1992 the 12 European nations are set for what they term "economic unification." Europe feels that it cannot compete with the US or Japan without this new "United States of Europe." The new Europe will be a force to be reckoned with competitively. Ponder this: The new unified Europe will have 320 million people and a GNP of around $4.6 trillion. It will account for roughly 20% of the world's trade -- more than either the US or Japan. The new Europe will be barrier-free and workers will be free to move to, and work in, any country they wish. The worry -- the new Europe could become "Fortress Europe," freezing out the competition. Under difficult world conditions or given a world depression that could easily happen.

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GOLD: I had dinner last week (in San Francisco) with old friend Bob Prechter of Elliott Wave fame. We noted that at 409 gold was at an 18-month low. On top of that, silver has cracked its '87 low and lumber is flirting with its '87 low. Cotton has collapsed, crude oil has sunk back to the mid-14 dollar-a-barrel range. Hogs have caved in. The grains have topped out, and cocoa has fallen to a 12-year low. In fact, the great majorty of commodities are in a "sell mode." Bob and I speculated on what the poor action in the commodities and precious metals could mean.

In harmony with my oft-expressed thought that the markets love to do what nobody wants and what nobody expects, I said that maybe the markets are saying that a sudden and severe bout of deflation is in the wind. While everyone (including the Federal Reserve Board) is worrying about inflation, "Wouldn't it be a shocker if the economies of the world started to deflate in earnest?" Prechter brought up the subject of real estate, and we both agreed that the wealth of America's citizens was in their homes, and that the worst possible economic disaster would be a collapse in real estate and home prices across the board. We also both agreed that home prices constituted by far the most overvalued and vulnerable area of the economy.

All right, let's turn to gold. Over the past few weeks gold has been flirting with its important 420 support level, closing a point over 420 on one day, then a point below 420 the next. But on Friday, September 16, gold broke decisively below 420, with the September (spot) gold futures contract ending the day at 411.70. No question about it -- that was a real breakdown. The next test will be the big even number -- 400.

But my position is that I'm not particularly concerned with gold's price since I've been saying all year that I want subscribers to be on a dollar-averaging program -- buying gold bullion coins on a fixed-dollar basis each month. Since $1000 will buy you more gold at 410 than it would at last year's peak-price of 496, I'm not complaining about the drop. I'm not complaining because I want to accumulate more gold, and the lower my average price, the better I like it.

However, what does concern me is the deflationary implications of the crack in the price of gold plus the accompanying weakness in the other precious metals. Veteran subscribers remember only too well that when gold topped out in 1980 and subsequently collapsed, that action marked the end of the wild Jimmy Carter inflation years.

If gold now cracks the critical 400 level, will such action usher in the start of actual deflation? And if so, with America (at every level) up to its neck in debt, what would actual deflation mean? No question about it in my mind, with the current almost unsustainable levels of debt, deflation would mean economic disaster. And if you wondered about the meaning of the October 19 stock market crash, this whole concept of potential deflation is a thesis worth pondering.

At any rate, in dealing with the markets I have learned to think about and be prepared for the unexpected. In a bull market the unexpected usually has to do with coming events that are far more bullish than anyone expects. In a bear market (as now) I reverse the process. Which means that I tend to think about bearish possibilities that no one is prepared for or is expecting. Along these lines, deflation ranks at the top of my list.

Thus I am watching gold closely. A gold price below 400, I feel, could be ominous. Furthermore, the weakness in commodities is being confirmed by the strength in bonds. If the economy is as strong as everyone says it is and thinks it is, then why aren't interest rates heading still higher and why are bonds so strong and why are the muni bond contracts at highs for the year? The two most sensitive gauges of inflation/deflation are gold and the bonds. So with gold weak and the bonds strong, what are the markets telling us? I don't know for sure, but they certainly are NOT saying "inflation."

LATE NOTES: What really caught my attention during the market's latest (August-September) rally was the dramatic lag in breadth. From the August 23 low (Dow 1989) to the September 16 high (Dow 2098) the Dow gained a total of 109 points. During the same period the advance-decline ratio (see page 2 chart) gained only 1.23 points, about half of what would have appeared in a strong market. Thus the rally from the August 23 low must go down as about the weakest upside action of the year.

I want to remind subscribers again that "values diminish throughout the length of a bear market." This bear market correction/recovery has now lasted a record eleven months, and on that basis time should be running out for the recovery. Let me put it another way -- because a bear market is in progress and because values are diminishing, the longer this stock market recovery lasts, the more dangerous the situation becomes and the nearer we are to trouble.

PS -- In answer to many letters inquiring about classic Dow Theory books mentioned here, I am sorry to say that they are out of print. They will have to be purchased via a book search (your local book store can arrange for a search). The books to find are: "The Dow Theory" by Robert Rhea; "The Story of the Averages" by Rhea; "The Stock Market Barometer" by William Hamilton; "The ABC of Stock Speculation" by S.A. Nelson; "How I Helped 10,000 Investors to Profit in Stocks" by E. George Schaefer. Eventually, I might reprint a few of these myself (years ago I reprinted 5,000 copies of "The Stock Market Barometer," but these have all been sold out.)

NEXT MAILING: Oct. 5